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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

NIC #01278-84
24 February 1984

National Intelligence Council

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MEMORANDUM FOR: Acting Director of Central Intelligence

FROM: Maurice C. Ernst
National Intelligence Officer for Economics

SUBJECT: Comments on McFarlane Memo Concerning
Impact of Escalation of the Iran-Iraq War

1. McFarlane expresses concern that the international economic repercussions of an escalation of the Iran-Iraq war "could be disastrous. The economic achievements of the last three years could be at stake." In my opinion this exaggerates the problem. Although an escalation of the Iran-Iraq war likely would result in higher oil prices, these price increases would probably be brief, and their negative impact on the world and US economies consequently would be small.

2. Consider the following:

- o The great majority of reasonable contingencies that could disrupt oil supplies would have an impact small enough to be offset through use of excess oil producing capacity in other areas. Only a closure of the Straits or damage to some very critical Saudi facilities would result in a significant net reduction of world oil supplies.
- o No one expects a closure of the Straits to last long; if only because the US would take action to reopen them. Saudi facilities are vulnerable, but one must assume extreme efficiency or good luck by the attackers to put most of the key ones out of commission.
- o Given current market psychology, it would take a large oil interruption to cause a big price spike. The oil market has hardly been fazed by escalation threats.
- o Once the interruption was over, oil prices would probably return to or below their previous levels. Unlike 1973 and 1979-80, the Saudis almost certainly do not want higher prices in the longer term. If anything, they believe current prices are slightly on the high side.

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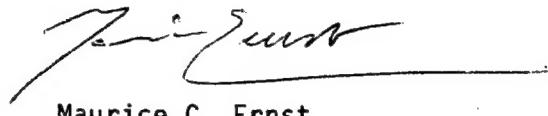
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3. McFarlane refers to CIA analysis as a basis for his gloomy assessment. The analysis in question probably uses runs from a macro model of the world economy, which is designed to analyze the impact of what I believe are very unlikely scenarios--namely, large oil price increases that last a year or more. In the far more likely case of a relatively brief interruption, inventory behavior is critical, and the model is not designed to shed any light on this problem.

4. We will be expanding on our analysis of the impact of oil supply interruptions in the SNIE: "World Oil Market Outlook: Key Political and Economic Dimensions" which will be completed within the next two or three weeks. CIA also is providing analytical support for the interagency taskforce on energy contingency planning. And today we are reviewing collection coverage and capabilities, including on economic facilities and targets in the Gulf.



Maurice C. Ernst

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Remarks

Executive Secretary

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February 23, 1984

~~SECRET~~MEMORANDUM FOR THE HONORABLE WILLIAM J. CASEY
Director
Central Intelligence Agency

SUBJECT: Possible Escalation of the Iran-Iraq War (S)

As a result of the excellent intelligence reporting from the CIA, I have become increasingly concerned in recent days over the possibility that the situation in the Persian Gulf could quickly deteriorate should the Iran-Iraq conflict escalate. As the CIA analysis has so clearly pointed out, the international economic repercussions of such an escalation could be disastrous. The economic achievements of the last three years could be at stake. (S)

I believe it is essential that the full range of implications, especially the potential international economic problems, be understood by all concerned parties. Because of the rapid evolution of the situation, I would like to discuss this issue with you and Cap Weinberger in order to seek your advice on any follow-up actions by NSC. Since I believe we should move expeditiously on this issue, I hope we can arrange a mutually convenient time to discuss the situation at 4:15 p.m. Friday, February 24 in Room 208, OEOB. (S)

Bud

Robert C. McFarlane

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